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First National City Bank
Monthly Letter
Business and Economic Conditions

New York, October, 1956

General Business Conditions

THE prospects for a strong fourth quarter have been confirmed by recent business developments. Industrial production, which bounced back promptly and fully after the steel strike, continued to advance in September. Steel mill operations are back at capacity, and the automobile industry is poised to begin large-scale output of 1957 models. Consumer buying has held close to the record August level, and retailers are already predicting good fall and record Christmas seasons. Moreover, the already optimistic outlook has been enhanced by evidence that business spending for new plant and equipment — a major factor in our current prosperity — will increase further in the fourth quarter. The growing demand for consumer and investment goods has been calling forth increased production which in turn has boosted employment and income, and so on around the circle with rising momentum which promises to carry over into the early months of 1957.

CONTENTS

The recovery in industrial activity, which carried the Federal Reserve index of over-all industrial production for August to the prestrike level of 141 from the July low of 136, reflected primarily the strength of the durable goods industries. Production of machinery, appliances, and transportation equipment other than autos has increased in recent months even more than is usual for this time of year.

Metal-fabricating activity as a whole advanced to a new record in August and continued rising in early September. Such performance in the face of a five-week steel strike is a measure of the sizable cushion of steel inventories which existed at midyear and the rapid rate at which they are being worked down. Despite the valiant efforts of the steel industry in pushing output to 100 per cent of capacity only six weeks after the end of the strike, the list of items in short supply is still growing. Between the anticipated revival in consumer durable goods demand, continuing defense needs, and the rising pressure for most types of machinery, equipment, and heavy construction, the steel industry has been getting more orders than it can handle.

Steel supplies may get even tighter if, as expected, automobile companies step up their November and December orders for steel for the new models. The size of the orders will depend on how well sales of the 1957 models go. Manufacturers have put intensive effort and hundreds of millions of dollars into new styling and technological innovations, and they hope that, as in 1955, the new models will capture popular imagination and stimulate sales. Ford, which will introduce its new models in early October, reports substantial rehiring and 20 per cent overtime schedules at assembly plants to fill dealer orders.

Even optimistic industry officials have not ventured to predict that 1957 will match the exceptional record of 1955 when 7.9 million passenger cars were produced and 7.4 million

sold in domestic markets. (Exports and increased dealers' stocks accounted for the difference.) The consensus seems to be that 6.5 million to 7.0 million passenger cars will be sold next year, an increase of 10 to 20 per cent over 1956. Production should be more closely in line with sales than it has been so far in 1956 because the excessively high stocks of new cars at the beginning of the year have been worked down — in some cases almost to the vanishing point.

Planning for Future Growth

During the past two months, steel companies have filed plans for expansion projects costing $1.3 billion with the Office of Defense Mobilization, hoping for permission to write off the cost of these new facilities in five years for tax purposes. According to *Steel* magazine these projects are only a portion of long-term expansion plans, which are expected to cost $6.3 billion in the five years 1956-60 and add 23.6 million tons of capacity to the January 1, 1956 total of 128.4 million tons.

This massive expansion has not been undertaken lightly. Time and again in the past the steel industry has had to contend with capacity substantially in excess of demand. In the postwar period, the question of over-expansion has been argued repeatedly. Yet today, even in the face of serious financing problems, the industry is not only expanding but raising its sights.

The same questions have been faced by business men generally who plan to spend $35.3 billion on new plant and equipment this year, an increase of 23 per cent over 1955 outlays. The Securities and Exchange Commission and the Department of Commerce report that, despite materials shortages, delivery delays, and tight money, business men surveyed in August expect to spend $420 million more on construction and capital equipment during 1956 than they anticipated spending six months earlier. Capital outlays have been rising steadily since early 1955 to the record annual rate of $38 billion scheduled for the fourth quarter, nearly 50 per cent greater than in the first quarter of last year.

In each of the first three quarters of 1956, the rate of plant and equipment spending has not increased quite as much as originally anticipated. For the most part, business has not been able to spend as rapidly as it planned because of materials shortages and the physical limitations of the heavy equipment and construction industries. For the same reason, final figures for third and fourth quarter outlays may fall somewhat short of current expectations, leaving more to be done in 1957.

Construction Trends

In addition to the commercial, industrial, and public utility construction included in plant and equipment outlays, other types of nonresidential construction have also registered substantial increases. In the first eight months of 1956, expenditures for private educational, religious, and institutional building were 9 per cent ahead of the corresponding 1955 period, while public construction of all types was up 6 per cent. Data on contract awards and backlogs of projects still in the planning stage indicate sustained demand for this type of work. Highway construction, up 14 per cent over 1955, has not yet felt the stimulus of the Federal-Aid Highway Act of 1956, but it reflects the same need for a better transportation system which inspired that Act. Construction of schools, water supply systems, sewers, and other public works is also increasing.

In spite of competition for materials and money from these private and public capital investment programs, home-building continues at the rate of more than a million units a year. The decline from the peak months of early 1955 was sharp but, actually, the number of homes started during the first eight months of this year has been roughly in line with the experience in 1951-54. The wonder is that home construction has held up as well as it has and that since February there has been little further decline in the seasonally adjusted annual rate of 1.1 million homes started.

Builders blame the shortage of mortgage funds for the drop in the number of homes started. However, they also have tended to narrow their market by concentrating on larger and more expensive homes. F. W. Dodge Corporation reports that construction contracts were awarded for 9 per cent fewer new residential dwelling units in August than a year earlier, but that an increase of 10 per cent in floor area per dwelling and a rise of 14 per cent in cost per unit boosted dollar volume 4 per cent over last year.

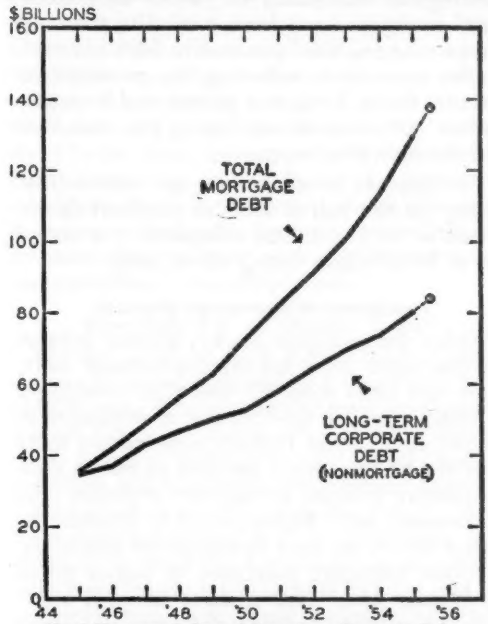
Pressure on Prices

The strength of consumer demand has been evidenced by mounting retail sales, which, on a seasonally adjusted basis, have set a new record each month since late spring. Altogether, the heavy demand from consumers, business, and government has put mounting pressure on prices. In recent weeks, the list of price increase announcements has been long and varied. Wholesale prices have risen about one-half per cent a month since the end of the steel strike (equivalent to 6 per cent a year). Consumer prices are expected to rebound in September, following a moderate decline in August, when a marked drop

in prices of fresh fruits and vegetables offset increases in nearly every other major category of consumer goods and services.

Despite the decline in August, prices received by farmers have been running above last year's levels and the volume of farm marketings is equaling or exceeding 1955. Income in recent months has been further boosted by the start of $58 million in wool incentive payments and $261 million in soil bank payments. As a result, reports on farm income are the most encouraging in a long time. The Department of Agriculture estimates that farmers' realized net income in the third quarter of 1956 reached a seasonally adjusted annual rate of $12 billion, the highest in 2½ years and a distinct upturn from the rates of $11.6 billion in the first half of this year and $11.3 billion in 1955.

Nevertheless, agriculture, along with homebuilding, still must be ranked among the softer spots in the economy. There are other industries, too, including textiles and lumber, which have not shared in the over-all advance in business. Most of these "problem areas" have been holding their own in recent months and are unlikely to become the focal point of a general weakening of activity.



Total Mortgage Debt and Long-term Corporate Debt, December 1945-55 and June 1956
(Long-term corporate debt for June 1956 estimated by this bank)

The Cost and Availability of Money

Shortage of borrowed money and rising interest rates have become objects of widespread public discussion. There are some people, to be sure, who express doubts that the Federal Reserve's restrictive credit policy is strong enough to arrest the enveloping wage-price spiral. But more is heard of the practical difficulties of raising funds. Bankers freely confess to their inability to cover all loan demands. Home-builders, faced by financing problems, have curtailed their planned operations. Industrial leaders are giving their new projects another look, moved by the need to measure the cost and availability of funds against the merits of specific capital undertakings. Government has its problems too, of designing securities to sell in a market supersaturated with credit demands.

Some fear that the credit brakes are taking hold too hard and may precipitate a general business contraction. This is always a risk in dealing with a boom. But while soft spots are apparent in some areas of business, as noted earlier in this *Letter*, there are still more evidences of forward momentum in the economy than of contraction. The rising drift of prices gives evidence that the Federal Reserve authorities, in raising discount rates in April and again in August, had a correct evaluation of the risks of inflation.

It is clear from the record that shortage of money is a product, not of any absolute shortage, but of expanded demand. Corporations are raising more money by bond offerings than they did in 1955 — or than in any other year. Banks are lending more money to business than ever before — and are increasing their loans to business faster than ever before. What the Federal Reserve is trying to do is skim the froth off the boom and hold credit expansion within limits consistent with a stable economy. There is no question of desiring to precipitate a contraction of available loan funds. The Federal Reserve has no authority to deny people their right to spend their own money as they please. They do have the right and responsibility to discourage borrowings that rest in the final analysis on extensions of credit by the Federal Reserve Banks.

Demands for borrowed dollars come from every side — even from abroad to the extent that borrowers can find access to our comparatively cheap market. The lion's share of the nation's current savings continues to be claimed by the building boom, although the flow of borrowed money into this area has slackened slightly as a result of increased business requirements for credit. While most people who want to buy or build houses find funds available, speculative

building has been hard hit. Rates on conventional mortgage loans have tended to move up from a range of 4½-5 per cent to 5-5½ per cent. At the same time, reflecting the pressures on them for funds, banks and savings and loan associations are competitively raising the rates they offer the individual saver.

The increase in total mortgage indebtedness during the first half of 1956, as the chart shows, amounted to $7.8 billion compared to a record rise of $16.2 billion during all of 1955.

Problems of Mortgage Market

Within the mortgage market investor interest has gravitated more toward conventional mortgages and away from VA and FHA mortgages on which rates are fixed by law or regulation at 4½ per cent. Some builders urge raising these rates one-half or even 1 per cent to restore their competitive position in the rate structure. The Government acted September 20 to broaden the market for 4½ per cent mortgages by scheduling increased mortgage purchases at higher prices for "Fannie Mae" (the Federal National Mortgage Association), raising the limit on saving and loan association borrowings from the Federal Home Loan Banks, and lowering from 7 to 5 per cent down payments of the FHA on homes appraised at $9,000 or less. While these steps were linked as measures to stimulate the supply of funds for home mortgages, the lowering of down payments works the other way around, increasing the demand for mortgage money and reducing the equity cover for the investor.

It is time that someone took a good look at the Federal Government's programs to encourage home-building on a cheap money shoestring. It was one thing to stimulate borrowing to build twenty years ago when millions of people were unemployed and savings funds were stagnating in inactivity. It is another thing to carry these programs on full steam when labor is scarce and savings inadequate to the demands.

An editorial in the August issue of *House & Home* magazine courageously faced these issues:

> Let's admit we've been living in a fool's paradise where we could sell terms and financing instead of houses — a fool's paradise where we could always compensate higher costs with slower pay-offs. . . .
>
> What difference did it make if your price went up from $10,000 to $12,000 if extending the mortgage from 15 years to 20 years made the monthly payment lower on the higher price? And if costs went up again, why not hide them even deeper by borrowing still more money and making the mortgage run for 25 years? Or 30 years? Or perhaps 40 years? . . .
>
> Until we get our costs in hand we are hardly ready for more money. Right now the first result of more money would be more inflation in land prices, more inflation in material costs, more inflation in labor costs — and more houses priced out of the market.

House & Home stated the problem simply:

> 1. Everybody wants to borrow a lot of money. In fact:
>
> 2. Everybody wants to borrow a lot more than anybody has to lend.
>
> 3. There is only one common pool of money from which to borrow.
>
> 4. Our industry [home-building] wants to borrow more money from this pool than anybody else, and
>
> 5. Our industry does not want to pay as much net interest as the other borrowers pay. That makes us low man on the totem pole.

Forecasting rising needs for credit to finance home-building, local government needs and industrial expansion in the years ahead, the editorial warns that we cannot develop the needed increase in savings unless we do something:

> Government must cut income taxes hard and leave more money for savings. It must reverse the tax policies born of the depression, when the New Deal set out to discourage savings and force consumption.
>
> Borrowers must pay more interest, to make it worth while for lenders to save.
>
> Prices must be kept level. People won't put money aside to spend tomorrow if they know they will get less for their money unless they spend it now.
>
> New ways to save must be developed.

The editorial cites as "nonsense" the idea that home buyers — who may be paying off $700 a year on a new $2500 car — cannot pay off more than $200 a year under a 30-year mortgage to buy a new $10,000 house:

> The 30-year mortgage makes our money problem worse instead of better, for three reasons:
>
> 1. It keeps home buyers from building up enough equity in their homes to trade them in for the down payment on a better house;
>
> 2. It makes us pay bigger discounts to get mortgage money, for lenders don't like to tie their money up for 30 years for the same yield as for 20 years.
>
> 3. It slows down the flow of amortization money back into the mortgage pool.

Pointing out that the biggest single source of money for new mortgages is the pay-off of old mortgages, *House & Home* urges a shortening of mortgage terms — increasing as it were "involuntary savings" — as the best way to generate more money for building.

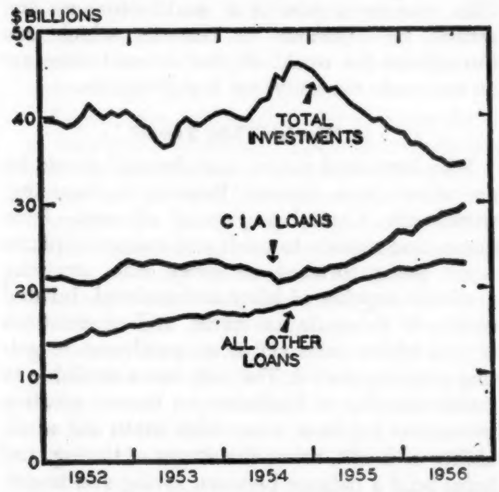
Congestion of Business Loan Demands

The dynamically expanding area of credit demand this year has been business borrowing to finance increased working capital requirements and, more particularly, sharply enlarged spending for modernization of plant and equipment. This is all good for the country but the sum total has to stand the test of available funds. What the credit structure has been doing this

year is shifting some of the flow of savings from mortgage investments into corporate bonds, meanwhile moving to rectify the over-all imbalance between savings and investment at a higher interest rate level.

It was apparent earlier in the year – from the expressed intentions of business to enlarge plant and equipment outlays – that the corporate bond market had a test coming. Many firms, anticipating mistakenly that the political influences of an election year would bring cheap money, postponed bond issues and sought financing through their banks. As the Federal Reserve raised discount rate, confirming intentions to restrain undue credit expansion, and banks raised loan rates, borrowers felt the pressure to go to the long-term market.

In order to accommodate the surge of business credit demands, as the chart shows, banks checked their lending in other directions, and continued to sell U.S. securities, cutting their holdings to the lowest level in 13 years and experiencing substantial losses in the process.



Weekly Reporting Member Banks' Investments; Commercial, Industrial and Agricultural Loans; and All Other Loans (except loans to banks)

(Monthly averages of Wednesday figures. September 1956 average through September 19.)

Thus a congestion of bank loan demands became a congestion of bond offerings, overtaxing the buying power of the market, particularly for corporate issues, and leading to sharp advances in rates of interest offered.

During September high grade issues of corporate bonds were being floated in a 4 to 5 per cent range compared to 3¼ to 3¾ per cent a year earlier. Institutional investors enlarged their buying power to acquire corporate bonds by selling or redeeming U.S. obligations, by cutting back on mortgage lending, or, in the case of corporate pension funds, by reducing purchases of common stock. Some borrowers decided to give up bond financing in favor of stock issues, or sweetened up bond offerings with privileges to convert into stock. Credit policy cooled bullish enthusiasm in the stock market, partly by subtracting from demand or adding to supply, partly by raising questions as to the availability of money to increase dividends, but most fundamentally by compelling revisions of the outlook for business profits and commodity prices.

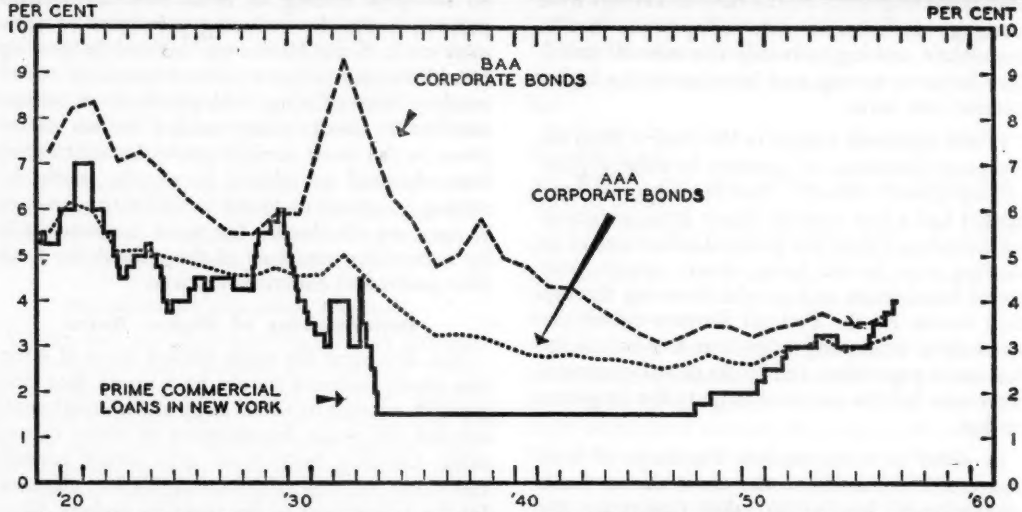
Beneficiaries of Higher Rates

The dim view the stock market takes of effective credit restraint should be a tip-off that people rich enough to afford risky stock investments are not the prime beneficiaries of rising money rates. Lending institutions gain direct benefits but these are financial intermediaries, channels for the investment of the people's savings. Since these institutions keep most of their funds continuously at work, the benefits of higher interest rates come more or less slowly, as loans and investments turn over. Since a restrictive credit policy depresses bond prices, selling bonds to gain advantage of higher interest rates involves losses that may take years to make up. Beyond these considerations, and higher operating costs that must be carried, the bulk of the residual benefits return to the public at large, through services rendered, lower costs of insurance and pension benefits, and higher rates offered to attract savings accounts.

The greatest body of beneficiaries of higher interest rates are the small savers, lacking the means to command large borrowing power, lacking developed skills in high finance, and seeking conservative investments as a measure of family security. It is this group that cheap money victimized over the twenty years of cheap money inflation. In a study last year for the National Bureau of Economic Research of "Interest as a Source of Personal Income and Tax Revenue", Professor Lawrence H. Seltzer of Wayne University found "that the importance of interest as a source of personal income has shrunk strikingly in recent years and that much the greater part of the total interest income received by individuals is received by those with small and moderate incomes."

Not a Political Question

The subject of credit policy was given attention in the platforms adopted by the two major political parties. Although some members of the President's cabinet had questioned the Federal Reserve discount rate advances last spring, the



Yields on Moody's Aaa and Baa Corporate Bonds, Annual Averages, and Prime Commercial Loan Rate in New York City

Republican platform endorsed the "present policy of freedom for the Federal Reserve System to combat inflation and deflation" and went on to say:

> The Republican party believes that sound money, which retains its buying power, is an essential foundation for new jobs, a higher standard of living, protection of savings, a secure national defense, and the general economic growth of the country.

The Democratic party, which was in power when the Federal Reserve System was founded in 1913 and again in 1951 when the System was freed from Treasury domination, attacked "hard money" as a Republican policy, stressed the disadvantages of higher interest rates to borrowers and of lower bond prices to government bond holders, and promised to reduce interest rates "in the service of our common welfare." Presumably this policy would have to be implemented by inducing the Federal Reserve Banks to inflate their currency issues. If the 1933-51 experience with artificially depressed money rates is any guide, the sequels would be rising prices and demands for the establishment of federal bureaus to tell people what they could charge for their products and earn by their work.

Rising interest rates were no invention of either the Democrats, who unpegged the rates in 1951, or the Republicans who have accepted further increases. Present rates in the United States are not "high" by historical standards – save those of periods when rates were being artificially depressed – or by the standards of prevailing rates overseas. The bulk of lending in the U.S. today is consummated in the rate range of 4 to 5½ per cent. Abroad borrowers of unquestioned credit standing often pay 6 to 10 per cent. This country is part of a world economy and cannot be oblivious to currents which run throughout the world. Higher interest rates are an economic necessity, not a political issue.

A World-Wide Trend

Why borrowed money is in demand should be no secret from anyone. Business is booming, world-wide. Capital projects of all sorts – from homes and schools to roads and industrial plants – are going forward on every side, straining available supplies of labor and material. Inflated costs add to needs for credit, and expectations of still higher costs act as an accelerant to getting projects started. The only force available to retain stability is limitation on money creation by central banks of issue. This limits the availability of credit, raises the wages of saving, and helps hold a balance between saving and investment.

Gaining this balance is not easy. In the background are the artificial cheap money policies, pursued during the depression and war, giving an upward slant to price levels. Low interest rates and rising prices made borrowing profitable and saving unprofitable. The surge of capital projects and rising price pressures exposed the inadequacy of saving. The rise of interest rates is a natural reaction from 20 years of cheap and depreciating money. Rates are highest where inflation has been worst.

The insidious idea that a little inflation is a good thing was taken up by Sir Dennis Robert-

son, speaking on problems of stability and progress at the first Congress of the International Economic Association in Rome a month ago. He pointed to the evil results of destruction of confidence in fixed-yield investments and finally in money itself, and said:

> I am not sure that in Britain the day when the Church of England climbed onto the bandwagon by entering the market for ordinary shares [common stocks] will not be seen in retrospect to have signalized the end of "a little inflation" as a respectable policy.

The United States has a strong savings flow – running to $18 billion a year for the accumulation of funds in insurance companies, savings accounts, and private pension funds. In light of the beating the saver has taken from price inflation it is surprising in many ways that the flow has been so well sustained. If saving ever stopped, the sky would be the limit on resultant price inflation and everyone's plans and hopes for social security would be irretrievably wrecked. The saver's patience with cheap money and inflation cannot safely be overstrained.

Nevertheless, a restrictive credit policy has a hard road to hoe. Political leaders have always been inclined to identify borrowers as the downtrodden poor whose means to salvation is to get more deeply mired in debt.

Beyond this, it is much easier to err on the side of indulgence of boom psychology and let credit inflation run its course to disaster. That was the lesson of 1920 and 1929. Borrowers include the aggressively enterprising and ebulliently optimistic members of society who are never reluctant to bring their influences to bear in favor of cheap credit. Yet, unimpeded, they can lead us all to ruin. Held in reasonable check, they can serve the essential function of drawing into productive use the nation's supply of savings, and earn and pay worthwhile rates of interest to the less venturesome who want peaceful security rather than excitement out of the economic process.

A Sobering Responsibility

A national election year is often a year of irresponsible promises to dish out more public funds without reference to where the money is coming from and who is going to pay. The 1956 campaign has been no exception to this rule. It was therefore heartening to hear Secretary of the Treasury George M. Humphrey, at the annual meeting of the International Monetary Fund and World Bank, address himself to the "sobering responsibility" of Ministers of Finance and Central Bank Governors to defend the value of money:

> It is our task to balance the demands for defense, high consumption, and for further economic development, against available resources. We have to steer as best we can the difficult and often unmarked channel between the whirlpool of inflation and the rocks of deflation.
>
> We who are gathered here – Ministers of Finance and Central Bank Governors – have a very special responsibility to the people of our countries. We are the trustees of the value of our people's work and skill which is to say, the value of their money. We are responsible for the value of their wages and salaries, their savings accounts, their pensions and insurance policies, and the other investments they make to provide for the future. This is a sobering responsibility and trusteeship. The average citizen cannot defend himself against the terrible hardships of inflation.
>
> Inflation brings with it grave social injustices and instability. It destroys not only the value of savings but also confidence, and security, and social values. Inflation is the cruelest form of theft – a theft with greatest harm to those least able to protect themselves. Inflation results in the destruction of the value of money. It is attractive only to those unwise politicians and others who are willing to sacrifice long-term good for unreal but falsely apparent immediate gain.
>
> We here have a special trusteeship, additionally, because inflation destroys the incentive to save and to invest funds. Without such saving and investment in productive enterprise, we cannot have the growing and dynamic economies from which can come more and better jobs and higher standards of living for our growing populations.
>
> It is far too little realized what an important contribution good money – money which people can trust – makes to the soundness of a nation. Confidence in the value of money is one of the greatest spurs to economic progress because it is an incentive to save, and it is our peoples' savings over the years – large and small savings alike – which have built up our countries.
>
> This is the trusteeship which we have – to avoid inflation. In this we are the trustees of the people and the future of our countries. We are the trustees for continued growth and continued peace and prosperity of our people.

The Federal Budget Outlook

The mid-year revision of federal budget estimates for current fiscal 1957 ending next June 30, released at the close of August, provides little encouragement for hopes of tax relief. The new estimates indicate a budget surplus for fiscal '57 of only $0.7 billion. This is an improvement over the $0.4 billion surplus projected last January when the President presented his fiscal '57 budget but a decided setback from the $1.7 billion surplus actually achieved in fiscal '56. The latter was used to reduce the federal debt. Secretary of the Treasury Humphrey has expressed his belief that, in the absence of need to stimulate the economy, a surplus around $3 billion would be required to justify tax cuts.

The failure of a larger surplus to develop is not the fault of the revenues, which are now being stimulated by prosperity as never before. Since January the Treasury has raised its esti-

mate of receipts in fiscal '57 by $4.3 billion to $69.8 billion. This is $1.7 billion higher than the record fiscal '56 receipts.

The trouble is with the upward surge of federal expenditures. Projected fiscal '57 expenditures have been lifted $4.0 billion since January to $69.1 billion. This is $2.7 billion higher than in fiscal '56 and the highest spending figure yet under President Eisenhower. Expenditures have climbed back for two successive years now from the $65 billion level to which the Eisenhower Administration had cut them in fiscal '54 and '55. Nearly half of those budget cuts have now been wiped out, as the following table shows:

U.S. Government Budget Expenditures, Receipts and Public Debt for Fiscal Years Ended June 30

(In Billions of Dollars)

	Fiscal 1953	Fiscal 1954	Fiscal 1955	Fiscal 1956	—Fiscal 1957— Jan. est.	Aug. est.
Expenditures	$ 74.3	$ 67.8	$ 64.6	$ 66.4	$ 65.1	$ 69.1
Receipts	64.8	64.7	60.4	68.1	65.5	69.8
Def. (—) or surplus (+)	—9.5	—3.1	—4.2	+1.7	+0.4	+0.7
Public Debt, June 30	$266.1	$271.3	$274.4	$272.8	$273.3	$271.4

The increase in over-all federal spending, and receipts, from fiscal '55 is even greater than the table suggests. The figures for fiscal '57 are not entirely comparable with those for prior years because the new pay-as-you-build federal highway program puts highway tax receipts and expenditures in a new trust fund and eliminates them from the regular budget totals. This is officially estimated to reduce fiscal '57 budget figures by about $1.1 billion for expenditures and $1.5 billion for receipts.

Where the Money Is Going

Major national security programs, though slashed $9.6 billion from the peak fiscal '53 levels, still account for $40.8 billion – 59 per cent – of total federal spending and are now tending to drift back up. Despite increases in efficiency and successful economies, costs have been raised by price increases throughout the economy as well as by the growing complexity of weapons and techniques. Military research and development expenditures are budgeted for a new peak of $1.6 billion in fiscal '57 and Atomic Energy Commission spending is slated to hit $2.0 billion, also a new high.

Nevertheless, the main source of the upward pressure on the federal budget is not the national security program but the widespread expansion of nondefense programs. Federal spending on "civilian" programs – now projected at a record $28.3 billion – has risen $4.3 billion or 18 per cent in the two years since fiscal '55 while national security spending is up only $198 million or one-half per cent. A 9 per cent a year rise in nondefense spending is worthy of note; national income, out of which the taxpayer finances federal spending, has been rising about 5 per cent a year since fiscal '55.

The spending increases are scattered throughout the budget with almost every major federal program requiring more money than it did in fiscal '55 or '56. The following table compares the new spending estimates with the January estimates and with actual expenditures in fiscal '55 and '56:

U.S. Government Budget Expenditures by Major Programs, Fiscal Year Ending June 30, 1957

(In Millions of Dollars)

	August est.	——— Changes from ——— January est.	1956 actual	1955 actual
Major nat'l security	$40,824	+ 454	+ 346	+ 198
Int'l affairs & finance	2,144	+86	+292	—37
Veterans' serv. & ben.	4,827	—52	+70	+370
Labor and welfare	3,001	+6	+225	+449
Agriculture	5,744	+2,330	+830	+1,333
Natural resources	1,183	+102	+172	+52
Commerce & housing	1,970	+699	—195	+348
General government	2,098	+336	+462	+392
Interest	7,156	+90	+304	+718
Reserve for contingencies	200	—25	+200	+200
Total	$69,098	+4,026	+2,706	+4,523

The largest increases show up in the Agriculture program, reflecting adoption of the new Soil Bank Plan to reduce agricultural surpluses and strengthen farm commodity prices. The $5.7 billion figured to be required in fiscal '57 is $1.3 billion or 30 per cent more than was spent in fiscal '55. Apart from national security, and contractual interest payments on the public debt, farm programs take more money than any other federal activity.

Spending on Commerce and Housing is projected at $2.0 billion, $699 million higher than was estimated in January but $195 million less than is shown for fiscal '56 spending. A major portion of the increase since January reflects Congress' failure to raise postal rates $350 million as the President requested. The $195 million decline from fiscal '56 spending is entirely attributable to the shift of the federal aid highway program to a trust fund outside the regular budget. Except for this change in accounting, spending on Commerce and Housing would have increased $955 million over fiscal '56.

Labor and Welfare spending has been raised $6 million since January even though Congress did not approve the President's initial $150 million request for federal aid to education. The mushrooming growth of federal welfare activities is illustrated by the 18 per cent increase in Labor and Welfare spending since fiscal '55. The projected $462 million increase for General Government spending since fiscal '56 is explained to the extent of $292 million by increased federal contributions to the civil service workers' retirement and disability fund.

Spending on International Affairs and Finance, mostly for foreign economic aid, is expected to run $292 million more than in fiscal '56 but $37 million less than in fiscal '55. Interest payments on the $275 billion public debt are expected to rise to $7.2 billion, reflecting the higher rates the Treasury has to pay on new borrowings and refinancings in the current tight money market. Increases in spending on Natural Resources reflect early stages of new flood control and reclamation projects which will require more money before they are completed.

Congressional Generosity

No other Congress – in peacetime or cold war – ever appropriated as much money as did the 84th Congress in the session just ended, and none in the past ten years granted in total so much of what the President requested. Senator Harry F. Byrd, veteran spokesman for government economy, described the performance as a "Congressional spending spree."

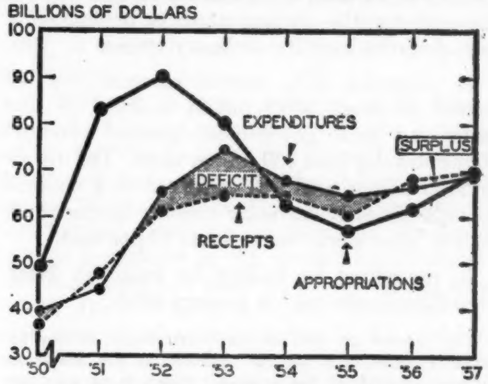
Congress' major economy move was to cut the President's foreign aid request $1.1 billion to $3.8 billion. But any saving for the taxpayer had been eliminated earlier when Congress voted to give the Air Force $900 million more than it had requested, over the objections of Defense Secretary Wilson and President Eisenhower. The Air Force was preparing recommendations on how the extra $900 million "could best be used" in July, weeks after the funds had been voted.

Equal generosity was shown in appropriations for river and harbor development and for flood control – known traditionally as the "pork barrel." Indeed, the Congress voted funds for work on 82 projects, with an ultimate cost of $1 billion, which the President had not included in his fiscal '57 budget requests. Acting to replenish the "pork barrel", Congress then voted an omnibus Rivers and Harbors and Flood Control bill which authorized over 100 additional projects for future construction at an ultimate cost of $1.6 billion.

The President vetoed this latter measure, pointing out that 32 of the projects authorized, involving financial commitments of more than $500 million, had not been given the normal review required by law.

The total of new spending authority made available for use in fiscal '57 rose to $69.7 billion, back above expected expenditure needs during the year for the first time since fiscal 1953.

One of the earliest lessons learned in bringing the budget back under control in fiscal '54 and '55 was the necessity of reducing the backlog of unused spending authority which had been



U.S. Government Net Receipts, Expenditures, and Appropriations (New Obligational Authority) by Fiscal Years
Figures for 1957 are Revised Budget Estimates

piled up under previous administrations. This was done effectively, by holding grants of new appropriations below expected expenditures. It is an ill omen that appropriations are rising above expected expenditures once more, permitting unused spending authority to accumulate and eventually loosening Congressional control over federal spending.

Spending or Tax Cuts

Clearly this is not the road to the tax cuts everybody wants and the political platforms promise. The plain truth is that expansion in federal spending programs, appealing as individual programs may seem in themselves, is siphoning off the natural growth of the revenues which otherwise could finance tax rate relief. This is not merely a matter of comfort for individual hard-pressed taxpayers. The striking fact in the United States today is the shortage of capital in relation to demands. To grow, the country needs a larger savings flow. Lightening the crushing burden of taxation could refresh the springs of individual incentive and initiative, enlarge the savings flow and take some of the load off credit policy as a block against inflation.

The practical alternative is to risk a return to big government, drift once more toward the welfare state where the only relief from taxation is perpetual inflation.

Socialist Sweden last month voted to continue the welfare state but one of the features of the election, according to the *New York Times*, was:

> . . . the upsurge of the Conservatives. They hit hard for months at high taxes, which strike at the heart of Sweden's economy. Every wage earner is paying about one-fourth of his income in taxes and, whether he is a Social Democrat or union member, he is privately grumbling about the big bite.

Thus in Sweden a realization of who pays in the end for the welfare state is beginning to percolate down to the ordinary citizen.

In capitalist U.S., federal revenues are expected to reach $69.8 billion in fiscal '57 and state and local government general revenues should take at least $30 billion more. The roughly $100 billion total will come out of a national income which is currently running around $340 billion. That works out to some 29 per cent.

In presenting his budget for fiscal '56, President Eisenhower said in January 1955:

> The present tax take of nearly one-fourth of our national income is a serious obstacle to the long-term dynamic growth of the economy which is so necessary for the future. There must be the means for providing more and better jobs not only for those who are working today but also for the millions of young people who will come of working age in future years. The stimulus of further tax reductions is necessary just as soon as they can properly be made.

These eloquent words are just as true today.

Nationalization and International Investment

While the annual meeting of the World Bank – an agency of international investment and development – was under way in Washington last month, newspaper headlines of the world were filled with consequences of an act which constitutes a major setback to investment and development. At the same time that representatives of so-called underdeveloped countries in one speech after another were pointing out the urgency of their needs, calling for freer lending at lower rates and with fewer strings attached, the world was witnessing an example of acute nationalism in the sudden flare-up in the Middle East.

The issues in the Suez Canal dispute are broad, partly technical, questions of international law, treaties, and sovereign rights. Immensely important, they are outside the scope of an economic journal such as this. One consequence of the matter, however, is wholly economic. That is the effect of nationalization on foreign investment and development.

Granting the principle that sovereign nations have the right to take over foreign properties – assuming adequate compensation – a pertinent question is whether it is in their interest to do so.

This question breaks down into two main parts. One is whether the countries which nationalize private property possess the technical and managerial know-how, the capital, and the access to markets necessary to operate these properties successfully. The other bears on the effect of nationalization on the availability of foreign capital for economic development in these and other areas.

Does Nationalization Pay?

As to the first point, the case coming immediately to mind is that of the seizure of the Anglo-Iranian Oil Company's wells and the great Abadan refinery by Premier Mossadegh in 1951, with results graphically recalled in a recent *New York Times* editorial as follows:

> It was a "triumph" of anti-colonialism, of nationalism and theoretically of the national sovereignty of Iran. Mossadegh was a hero to the Iranian masses and to all those in the Middle East who identified the operation of a great industry by a Western power with colonialism.
>
> Yet what was the result? The Abadan refinery, the largest in the world, closed down for three and a half years. The production of Iranian oil was reduced to a trickle. The economy of Iran collapsed and with it all Mossadegh's promises of social and administrative reforms.

It was not until after Premier Mossadegh's overthrow by more responsible people in Iran who saw what was happening to the country that an agreement was negotiated. Iran kept the Abadan refinery and other oil installations and paid compensation to the dispossessed owners, the Anglo-Iranian Oil Company. An international consortium of eight oil companies agreed to operate the refinery and the oil fields, sharing the profits with the Iranian Government. Under this arrangement, utilizing Western administrative and technical experience and marketing facilities, the properties are again producing and yielding rich tangible benefits instead of empty promises to the Iranian people.

Another case is that of the nationalization of the tin mines by Bolivia in 1952. This, too, was supposed to be a great victory for the people. But somehow it hasn't worked out so well. In April this year President Paz Estenssoro, under whose regime the nationalization was effected, was quoted as admitting that after four years of government operation the vast enterprise had been a failure economically. The President placed the blame partly on lack of technicians and capital. He also cited low productivity on the part of the mine laborers. They worked harder for the private owners than they did for the Government, he said.

Other cases could be cited. In general, the record shows – where nationalization has been tried – not more, but less, production has resulted. Compare the development of the petroleum industry in those countries which have permitted private "exploitation", and in those which

have not. In the former, output has forged ahead, broadening and strengthening the national economy, and multiplying the national wealth and income. In the latter, where petroleum has been kept a government monopoly, progress has lagged or stood still; some countries with ample reserves in the ground have been unable to supply even their own needs and have been dependent upon foreign oil resources.

Effects on International Investment

Then there is the matter of the effect of nationalization on international investment.

Time and time again in international conferences representatives of the underdeveloped countries have risen to plead their case for capital to carry out their plans and programs for economic betterment. At the annual meetings of the International Monetary Fund and the World Bank last month, spokesmen for India and Cuba characterized the needs as "urgent." The speaker for Indonesia described the underdeveloped countries as engaged in a "desperate" struggle against poverty. Declaring that economic development "has become the goal and ambition of millions of people," the Finance Minister of Mexico, Dr. Antonio Carillo Flores, told his audience that these desires create immense needs that are "urgent everywhere and cannot be postponed."

The tragedy of Suez and of a whole succession of government acts and policies in other countries that have appeared unfriendly to foreign capital lies in the serious setback administered to prospects for satisfying these needs and aspirations. Nationalization of foreign assets, repudiation of debt, and anti-foreign discriminations in various shapes and forms — no matter how justifiable they may appear on the spot — afford poor inducement for outside people to risk either their tax money or their private savings in areas that do not recognize a code of fair conduct in international financial relations. Who wants to throw good money after bad?

Nor is the answer sufficient that foreign capital has no cause for complaint if its nationalized assets are taken over at "fair value." Foreign capital does not go into a country and spend large sums for development, often with little or no return for years, for the purpose of being suddenly and arbitrarily dispossessed even under fair terms of compensation. And too often in the past the terms have been far from fair. At best, "fair value" is a difficult and complex question to settle; at worst, it can be a flimsy cover-up for confiscation.

As Robert L. Garner, president of the International Finance Corporation, the new subsidiary of the World Bank for promoting private investment in foreign countries, told the meeting in Washington, confidence in governments will "largely determine the pace and volume of private investment in the developing countries. And confidence is a plant slow to grow, but easy to kill." He went on to point out, "Unfortunately, each example of arbitrary action in the world of international business, wherever located, affects not only the parties directly involved but spreads its influence to far distant areas." No one knows, when, where or how the next blow will fall.

Anything that destroys confidence in international investment hurts all countries. The question is, which suffers more: the investing countries, which by and large have plenty of opportunities to put money to work at home at far less hazard than abroad, or the underdeveloped countries themselves, whose chronic shortage of capital is one of the principal impediments to achieving the material progress for which they are all so earnestly striving?

In the words of Eugene R. Black, president of the World Bank, in his address to the annual meeting:

> The danger today is not that the foreign investor will ask too much of a developing country, but that the developing countries will do too little to attract him. Today the foreign investor cannot go into a country unless he is actually wanted by the people of the country. By indulging the myth that the private investor is trying to force an entry to engage in some sort of evil exploitation, the less developed countries are cutting themselves off from one of the most productive sources of development assistance available to them. The capital and skills which the private investor brings with him may not be available from anyone else. Particularly he brings with him the skills of industrial management — skills which have to be seen in action to be learned. If a country is bent on industrializing and having the benefits spread broadly among the people, it can do itself no better service than to seek out the private investor abroad who is willing to risk his capital on the chance of a fair return on a successful venture.

These words go to the heart of the whole problem of international investment and development.

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